TESORO

Tesoro Hawaii Corporation
733 Bishop Street Suite 2700
P.O. Box 3379
Honolulu, Hawaii 96842-0001
808 547 3111
808 547 3145 Fax

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VIA FACSIMILE (808-587-3820)
AND E-MAIL (mtome@dbedt.hawaii.gov)

Ms. Maria Tome
Alternate Energy Engineer
Hawaii State Energy Office
The Hawaii Fuel Ethanol Working Group
P.O. Box 2359
Honolulu, Hawaii 96804

Preliminary Comments by Tesoro Hawaii Corporation on Unofficial Draft Administrative Rules and Related Reports

Dear Ms. Tome:

Thank you for the opportunity to comment on the unofficial draft administrative rules (the "2003 Draft Rules") prepared by the Hawaii Fuel Ethanol Production Working Group earlier this year, and related Stillwater and BBI reports (the "Ethanol Reports"). We are looking forward to the Ethanol Working Group Meeting on January 13, 2004, and further discussions with other interested parties.

We want to begin by emphasizing that Tesoro Hawaii Corporation ("Tesoro") supports the State of Hawaii's energy policy and desire to increase the security and self-sufficiency of energy supplies to the region. Tesoro appreciates the importance of ethanol to the agricultural segment of our State. However, it is equally important to the State that the petroleum industry remains strong and viable. The playing field should be level for everyone involved with ethanol.

In this context, Tesoro has reviewed the proposed introduction of ethanol blending into Hawaii. We have concluded that ethanol blending into gasoline will cause substantial capital, manufacturing and operational issues for Tesoro that need to be addressed by the Ethanol Working Group. Moreover, ethanol blending into gasoline in Hawaii presents unique challenges to all of the stakeholders versus the comparable situation on the Mainland because of our geographic isolation. It is also critical to note that the use of ethanol in Hawaii is being driven by very different factors than in some parts of the Mainland. For example in California, ethanol is used as an oxygenate for regulatory compliance that is not applicable to Hawaii. In Hawaii, ethanol is being promoted for agricultural and alternate fuel purposes. Consequently, we should have much more flexibility in Hawaii for the implementation of ethanol.

The ethanol program also raises larger issues that create conflicts with other goals of the State. Without assistance for the capital burden of the ethanol program, the ethanol implementation measures may cause an upward pressure on gasoline prices in the State. This is in clear conflict with the goal of the State to try and reduce Hawaii gasoline prices. In particular, the Hawaii gasoline price control legislation is scheduled to go into effect on July 1, 2004. The West Coast price quotes that will be used to compile the weekly average price ceiling for Hawaii gasoline do not reference any ethanol blends, and consequently will not provide for any price recovery of the additional costs associated with the introduction of ethanol blending in Hawaii.

In this regard, we note that the State has provided generous tax credits to the ethanol producers. In recognition of the considerable capital expense involved in the introduction of the ethanol program in Hawaii, and in particular the staggered nature of the program, Tesoro believes that these tax incentives should be extended to the gasoline distributors who incur capital costs.

We also think that the broader picture of what is occurring with ethanol and the potential for a renewable fuels mandate at the national level be considered by the Ethanol Working Group as part of the development of the 2003 Draft Rules. The National Energy Bill, that contains a 5 billion gallon renewable fuels mandate, narrowly failed passage in the US Congress before the winter recess. Congress plans to bring the bill up when they return in mid-January 2004. If the National Energy bill passes, Tesoro believes that state mandates may be unnecessary.

We will expound on these issues further in this letter as follows:

<u>COMMENTS - 2003 DRAFT RULES</u>

1. In addition to the demands on capital, the implementation schedule, as written, is not realistic for engineering and permitting reasons. More specifically, the nature of ethanol blending in gasoline requires that the ethanol be added at the terminal rack prior to distribution by truck. Consequently, each of our terminal facilities will likely require expensive modifications to facilitate ethanol blending. It is infeasible to provide ethanol storage and blending capability at our terminals before the proposed implementation date of June 1, 2004. The prerequisite engineering and permitting will take some months, prior to construction of tankage, piping and blending facilities.

2. The proposed gradual rollout of the ethanol blending program will result in significant additional costs to the gasoline refiners and distributors. As you know,

the current gasoline blends in Hawaii have a maximum vapor pressure limit of 11.5 psi. Ethanol addition will boost the vapor pressure of the gasoline by approximately 1 psi. Therefore, it will be necessary to reconfigure refinery gasoline blending to prepare a base gasoline blendstock that can accommodate the addition of 10% ethanol without exceeding the regulatory vapor pressure cap. This special blendstock is referred to as "Before Oxygenate Blend" or "BOB."

The gradual rollout of the ethanol program proposed under the 2003 Draft Rules require 35% of the gasoline pool in Hawaii to be in compliance by June 1, 2004, 70% compliance by January 1, 2005, and 85% compliance by January 1, 2006. This will require our refinery to blend multiple gasoline blends during this rollout period to accommodate the range of gasoline products mandated under the rules. More troubling, this may be a permanent situation if the rollout is not amended to require 100% compliance at some point.

During either the temporary, or possibly permanent rollout period, we will need to refine four instead of the current two gasoline blends, as follows: (1) Regular Unleaded BOB; (2) Regular Unleaded Conventional; (3) Premium Unleaded BOB; and (4) Premium Unleaded Conventional. Further, each terminal facility in Hawaii will require storage for these four gasoline blends. These duplicative infrastructure requirements will unnecessarily multiply the capital and operational costs for the distribution system. Consequently, the concept of the gradual rollout, while attractive in theory, is highly flawed in practice unless a solution is found to avoid the need for simultaneous BOB and conventional blends for regular and premium grades of gasoline.

3. The 2003 Draft Rules essentially require the gasoline distributors to manage the ethanol supply in the State in order to achieve compliance with the ethanol mandate. As written, the 2003 Draft Rules require the distributor to apply for exemptions in the event that sufficient quantities of competitively priced ethanol are not available to meet the minimum requirements. Under the 2003 Draft Rules, it can take up to 45 days for the exemption request to be heard, and the distributor is exposed to severe penalties during this period if an exemption is not granted.

Moreover, there is no requirement for the local ethanol producers to provide a sufficient supply of ethanol to meet the mandate schedule proposed in the 2003 Draft Rules, or even to forecast the availability of the ethanol supply. Without important changes to the 2003 Draft Rules in this regard, the distributors will be required to maintain large reserves of ethanol, with the attendant increased infrastructure costs at each terminal.

4. As a refiner as well as a distributor of gasoline, Tesoro is concerned about the security and reliability of the ethanol supply within the State and the resulting

effect on Tesoro's refinery and terminal operations. As discussed in item 2 above, the refinery must produce a separate set of gasoline BOBs to address vapor pressure issues. There is the second, and equally important issue of compliance with octane requirements. The BOBs will have an octane below the finished gasoline octane number to allow for the ethanol octane boost. Consequently, if there is an interruption to ethanol availability, Tesoro and other distributors will have BOBs in their terminals, that will not meet the Federal Octane Rule, which will subject Tesoro and other distributors to penalties for non-compliance. Again, this may lead to a gasoline distributor having to hold large reserves of ethanol in each terminal at great expense.

5. The ethanol mandate in HRS §486J-10 requires ethanol to be blended at ten percent by volume. The proposed rules should be amended to allow a blend range such as 9.5 to 10.0% to allow the distributor to meet the requirements of the ethanol mandate without exceeding the ten percent threshold advised by motor vehicle manufacturers.

6. Related to the motor vehicle warranty issue, Tesoro requests that the proposed rules be amended to include a waiver of product liability for the distributors against any motor vehicle damages incurred as a result of the introduction of ethanol into the State's gasoline pool.

7. The definition of "Distributor" in Section 7(1) of the 2003 Draft Rules should be further examined to ensure that there is no confusion as to which party is responsible for the ethanol blending and related issues such as the tax credit. This is particularly important when the BOB will be handled by multiple parties prior to rack, and in situations where one distributor is using the facilities of another distributor to distribute its gasoline.

<u>COMMENTS - STILLWATER REPORT "HAWAII ETHANOL ALTERNATIVES"</u>

1. Tesoro agrees with the conclusion of the Stillwater Report that Hawaii's ethanol production can be exported to California at a significant benefit over local consumption. Recent regulatory changes in California have boosted that state's demand for ethanol to 900 million gallons per year. This provides the potential opportunity to expand Hawaii's ethanol production facilities to larger and more efficient operations including improved Btu conversion ratios to further the environmental goals of the ethanol program.

2. Tesoro agrees with the general findings of the Stillwater Report that the impact of an ethanol mandate in Hawaii on the local refining infrastructure is likely to be more severe than elsewhere in the US. In particular for Tesoro, the gasoline production capability of the refinery is already under-utilized at times,

and the effect of introducing 10% ethanol blending into the gasoline pool will further reduce the utilization of our manufacturing assets.

We have performed some preliminary estimates and agree with the Stillwater Report that the Tesoro Refinery will be adversely affected by both the cost to produce a low RVP ethanol BOB, and the resulting disposal of the displaced light naphtha component of the gasoline at reduced margins. Moreover, there is no benefit to Tesoro from the low sulfur content of the ethanol since the gasoline manufacturing process at our refinery already produces an ultra-low sulfur gasoline product.

However, we disagree with the Stillwater Report's assertion that the Tesoro Refinery could potentially recover the lost margin on the reconfigured gasoline blend through increased rack prices. This would imply that all of Tesoro's gasoline sales are sold through the rack and that the rack price can be adjusted accordingly. In fact, Tesoro has large volume, long-term commitments on gasoline sales to other distributors in the State that are tied to independent markers. Consequently, in some marketing channels, Tesoro may face a loss of margin in manufacturing the ethanol BOB without the opportunity for an offsetting benefit from the Federal excise tax credit (since the Tesoro sale occurs prior to the addition of ethanol), or from a possible upward adjustment in gasoline rack pricing. There is also the pending Hawaii price control legislation that may prevent the recovery of these lost margins through increased prices at the rack.

3. The distribution of ethanol within the State of Hawaii will present unique challenges. Hawaii has sixteen terminals distributed across Oahu and the Neighbor Islands. Ethanol must be shipped to the truck loading rack from the point of production. Moving ethanol by barge to the gasoline distributors while maintaining its integrity will be a challenge for the ethanol producers.
The Stillwater Report touches on these issues but does not reach any comprehensive resolution. Tesoro is concerned that the ethanol producers are expending significant effort on the development of their production facilities, but not giving sufficient consideration to the quality control challenges of their ethanol distribution to the gasoline blenders.

4. As we previously discussed under our comments to the 2003 Draft Rules, Tesoro has concerns over the cost of the new facilities required to blend ethanol. Of particular concern is the lack of sufficient ethanol production in Hawaii to meet the requirements of the 10 percent ethanol mandate in the first phases of the gradual rollout. The potential increase in costs to operate a dual gasoline system in the State was also not sufficiently addressed by the Stillwater Report. In other jurisdictions that have introduced an ethanol mandate, there is sufficient ethanol supply to enact the mandate without the need for expensive and inefficient dual gasoline systems. Until Hawaii can produce upwards of 40 million gallons of

ethanol per year, we will be required to produce four blends of gasoline. This will entail additional capital expenditure at the refinery and additional tankage and injection equipment at each terminal. Our preliminary estimate for just the terminal installations exceeds one million dollars per installation.

5. One of the proposals in the Stillwater Report is to produce ethanol for local consumption at the point of production only. For example, ethanol production in Maui would be consumed on Maui only. Tesoro disagrees with this proposal. Any differentiation in the type of gasoline sold within the State of Hawaii will result in the production of multiple blends of gasoline at the Tesoro Refinery. Therefore, Tesoro believes that the ethanol mandate should be applied uniformly across the State. Tesoro would also be opposed to granting any exemptions to specific parties that would create a permanent need for multiple blends at the Tesoro Refinery.

6. An area that was not addressed by the Stillwater Report is the projected reliability of the ethanol supply within Hawaii. In other areas of the country that have introduced ethanol blending, the gasoline distributors have access to many alternate sources of ethanol available by truck or rail. Hawaii will be unique in enacting an ethanol mandate that will be reliant upon local manufacturing capabilities without recourse to readily available alternate ethanol supplies. The potential for disruption to the gasoline supply chain in Hawaii can be mitigated by mandating that the ethanol producers maintain large reserves of finished ethanol product at the point of production.

COMMENTS – BBI REPORT "ECONOMIC IMPACT ASSESSMENT FOR ETHANOL PRODUCTION AND USE IN HAWAII"

1. Tesoro believes that the value of the economic evaluation of ethanol blending in gasoline in Hawaii by the BBI Report is very limited because of the questionable assumptions used for the evaluation. More specifically, Tesoro believes that it is unlikely that ethanol will be blended into gasoline at a central location at Barbers Point. While a central blend point would be attractive, our experience in ethanol blending in our operations in other areas of the US leads us to believe that the most appropriate location for blending ethanol into gasoline is at the truck rack. As stated above, Tesoro has prepared initial capital estimates for terminal modifications that require more than one million dollars per site.

2. In addition, the increased gasoline consumption projections assumed in the BBI Report appear extremely unrealistic to Tesoro. We believe that it is much more likely that the introduction of ethanol blending into gasoline in Hawaii will not result in additional gasoline sales. In fact, we believe gasoline sales will remain static and our refinery will produce a lower volume of gasoline blendstock

once ethanol blending is required. Tesoro anticipates reduced utilization of its manufacturing assets in Hawaii and an on-going economic cost to produce a low RVP ethanol BOB.

3. Tesoro is also troubled by the apparent miscalculations in the report that are used to support the assumption of an expanding gasoline market. In particular, Table 18 in part V "Ethanol Market Potential" has amounts for projected gasoline usage that are far in excess of the annual growth factor of 1.05% stated just above the table.

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This concludes Tesoro's preliminary remarks on the 2003 Draft Rules and the Ethanol Reports. We appreciate the opportunity to provide these comments, and believe the Ethanol Working Group is serving an important role in identifying and addressing the issue of ethanol in Hawaii. Tesoro looks forward to continuing this dialog next month at the scheduled meeting of the Ethanol Working Group on January 13, 2004.

If you have any questions or if I can be of any assistance prior to the meeting, please do not hesitate to contact me at 285-1565 or by e-mail at dleonard@tesoropetroleum.com.

Yours very truly,

TESORO HAWAII CORPORATION

David Heerwald Leonard, P.E., Esq.
Vice President and General Counsel

cc: Paul Cannizzo
Kathleen Fitzgerald